Market Update

30 September 2016

Back in the 1960's and 1970's, governments took it for granted that it was their responsibility to pep up demand. The problem was that politicians were good at cutting taxes and increasing spending to boost the economy however hopeless at reversing course when such a boost was no longer needed. Fiscal stimulus became synonymous with even bigger government. Today, the task is to find a form of fiscal policy that can revive the economy in the bad times without entrenching government in the good.

This means going beyond the standard response to calls for more public spending: namely, infrastructure investment. To be clear, spending on productive infrastructure is a good thing. Much of the rich world could do with new toll roads, railways and airports, and it will never be cheaper to build them. To manage the risk of white elephant projects, private sector partners should be involved from the start. Pension and insurance funds are desperate for long lasting assets that will generate the steady income promised to retirees.

Infrastructure spending should be one of the methods used to prop up weak demand. Capital projects do drive and fine tune the economy. However, they require onerous planning, have long delivery dates and risk becoming bogged down in politics. To be effective, fiscal policy must mimic the best features of modern day monetary policy, whereby independent central banks can act

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immediately to loosen or tighten as circumstances require. In other words, as governments around the would embark on direct injection of capital into specific projects, central bankers must stand ready not just to increase interest rates accordingly, but also decrease rates as economic growths move from tepid to over heating. Past historical efforts by central bankers provided mixed results with central banks acting too soon resulting in an unnecessary recession or acting too late creating an over heated economic bubble in broad asset classes.

Rhetoric and grandstanding aside, the political debate between Trump and Clinton did bring clarity on key economic issues which both candidates will put in force once in office:

- The use of helicopter money to fund infrastructure and key economic sectors.
- Repatriation of foreign corporate assets back into America in exchange for jobs.

So here is what we are looking at once the election is over in America. Approximately $4 trillion dollars will be allowed to flow back into the country with another $3.6 trillion needed to maintain and repair infrastructure by 2020 according to a report by the American Society of Civil Engineers.

The old continent is back in the ugly with Deutsch Bank and Commerz Bank. Deutsch Bank (Germany's largest bank) shares have dropped 65% since a peak in July 2015. Commerz Bank (Germany's second largest bank) announced it will cut 9,600 jobs and suspend dividend payments until it reaches profitability. Commerz executives estimate a return to profitability by the end of 2020. The EU and the ECB need to act fast with a deep strategy on how to stabilize Europe's two global banks. A run on these two banks will see assets move into North America.

Recent stability in the Chinese economy masks deep rooted problems that threaten to rattle global markets in advance of a leadership change next year. Ignoring these risks is shortsighted, said authors of the China Beige Book International, a quarterly survey that tracks the world's second largest economy. Data from the group's third quarter survey of 3,100 Chinese firms and 160 bankers point to some potential problems. New growth engines intended to shift the economy away from investment toward consumption led growth are increasingly wobbly as corporate cash flow is squeezed and Beijing doubles down on traditional engines to stabilize output. China's economy twists and turns, happening to end up at the same spot. There are real problems below the surface. Growth in China's service industry, a cornerstone of its planned transition to a new and more sustainable economic model, weakened during the third quarter as financial services, private healthcare, telecommunications, media and other subsectors lagged. In retail, the apparel, luxury goods and food sectors slowed, as online retailers continued to cannibalize in stores sales. Despite Beijing's pledge to reduce excess industrial capacity and pare debt, China remains heavily dependent on government spending to power traditional debt driven growth engines. Much of the economic momentum during the third quarter came from infrastructure, manufacturing, commodities and real estate and many of these sectors are in danger of losing momentum.

An unexpected announcement from Saudi Arabia has sent oil prices upwards and speculators scrambling. Oil prices settled at a more than one-month high on Thursday as optimism over an OPEC plan to limit output was offset by questions over its ability to rebalance a heavily over supplied market.

As an interesting lead in to what lead the surprise announcement it is important to note that Saudi Arabia will suffer a fiscal deficit equal to 13.5% of GDP this year, as estimated by the IMF (International Monetary Fund). When it comes to economic growth, Saudi Arabia is slowing sharply to about 1% this year while Iran, its nearby rival, is accelerating toward 4%. The pump as "we please" policy brought chaos to the oil industry as prices tumbled from $100 a barrel to a 12-year low of less than $30. Oil and energy producers tightened their belts, canceled projects and sold assets. Regardless of it all, all oil companies have kept pumping out oil. This looks to continue even as the Saudi's advocate a reversal. Producers who fell in love with drilling projects approved during the boom years of $100 + a barrel have kept production humming from the Gulf of Mexico to Brazil. Iran will be exempt from capping production, a major concession by Saudi Arabia. Many of the details remain to be worked out and the group will not decide on targets for each country until its next meeting at the end of November.

Just as Saudi Arabia agreed to pare output, the world's most expensive oil field, the $50 billion Kashagan in Kazakhstan, is about to go online. The project, nearly a decade in the making, will add thousands of barrels of additional production in 2017 to an already oversupplied market.

Russia, too, has kept the pumping party going. As OPEC was meeting in Algiers, Moscow, they announced that the country's output smashed a post-Soviet record in September, reaching 11.1 million barrels a day, up about 400,000 barrels from August, roughly what OPEC member Ecuador produces. Mexico, Norway and other non OPEC countries may join Russia in pushing forward just as American shale drillers are. Analysts were surprised by the OPEC decision and highly skeptical that Saudi Arabia can get their producers to cooperate. As with low interest rates suppressed oil prices look to be part of the economic reality.

The Canadian economy surpassed expectations in the third quarter, fuelled by a rebound in oil and gas extraction that saw disruption due to wildfires in Alberta earlier this year. Data from Statistic Canada realized today show gross domestic product, GDP, grew 0.5% in July topping analysts' forecasts of 0.3%. June's growth is unrevised at 0.6%.

Median Canadian incomes have jumped more than 50% since 1976 while governments continue to spread the "myth" that middle-class families are falling ever behind. That's the conclusion of a new Fraser Institute report, released Wednesday, that digs into the widely held perception that the middle class was in better financial shape decades ago. The statistic most commonly used to suggest middle class stagnation is a 7% drop in the inflation-adjusted median income of Canadian families between 1976 and 2011. However, the Fraser Institute report argues that the statistics do not give a full and accurate picture of the state of the middle classes' finances. After looking at a number of factors that influence income, such as purchasing power, family sizes and government transfers, the Fraser Institute researchers found that the per family member annual income of the middle class rose to $39,200 from $25,771 over a 35 year span.

The reality is middle class incomes have risen dramatically since the 1970s, and those incomes go a lot further today in terms of purchasing power.

We are witnessing the end of a darling. Blackberry announced it will close their entire device making sites in North America and hand over production to an overseas partner. Blackberry's leadership is betting large on cyber security software and services. This is already a highly aggressive space which is evolving at hyper speed. Say good bye to the worlds most trusted and secure mobile device.